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LEGAL AND REGULATORY ASSESSMENT: KYRGYZ REPUBLIC

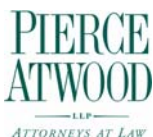
**Regional Energy Markets Assistance Program
(REMAP)**

**Программа по содействию региональным
энергетическим рынкам Центральной Азии**

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Prepared for:

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I. INTRODUCTION

The following is a baseline assessment of the current and proposed legal and regulatory framework for the energy sector in the Kyrgyz Republic. The assessment is prepared by Pierce Atwood, under contract with USEA, supported by USAID. It is a part of Component Three of the Regional Energy Markets Assistance Program (“REMAP”) to assist in the development of an electricity market in the Central Asian Republics (“CAR”).

In light of changes in the Constitution of the Kyrgyz Republic in November 2006, the passage of another Constitution by Parliament at the end of December 2006, the resignation of the Government on December 19, 2006, the appointment of a new Prime Minister on January 29, 2007, the appointment of a Minister of Energy, Industry and Fuel Resources on February 8, 2007, and the accompanying restructuring of the regulatory authority in early 2007, this Assessment has been developed on an urgent basis to address current institutional needs and offers a first stage analysis.

This document is the result of a one week visit to Bishkek and meetings with local stakeholders, work with REMAP experts, and careful review of applicable legislation and background materials to identify appropriate next steps. In the event that further decision is made by USAID to support restructuring and institutional capacity building of the regulatory authority in the Kyrgyz Republic, the next step is directed, hands-on work with Kyrgyz stakeholders through a working group of energy sector experts, with a focus on legal and regulatory issues. Such working group should be established and represented at a high level.

We conclude that revision of the primary energy legislation and the regulatory institutional framework is necessary and timely; and should take place through a High Level Working Group established by the new Minister of Energy, under the support of the President and Prime Minister’s offices, with inclusion of local stakeholders. For optimal success, such Working Group should be led and managed at the most senior Kyrgyz level. REMAP experts would welcome the opportunity to assist this effort in an advisory capacity, providing consulting assistance to the High Level Working Group as it drafts proposed legislation and offering expert input as to best international practice.

This Assessment discusses the purpose and mandate of any such Working Group.

The text of the Assessment is in six parts:

1. Introduction
2. Executive Summary
3. Background
4. Principal Findings

5. Principal Recommendations (Roadmap)
6. Conclusion

Attached as Appendices are:

1. International accepted attributes of an adequate legal and regulatory environment and their sources
2. List of legislation reviewed
3. List of principal background materials on the Kyrgyz energy sector and energy issues in CAR
4. List of principal organizations interviewed

II. EXECUTIVE SUMMARY

Any assistance in the legal and regulatory development of the energy sector in the Kyrgyz Republic should involve a reassessment of the fundamental framework structure and should concentrate on institutional governance and capacity development.

The current regulatory structure is in flux, and major changes are anticipated within the next several months. In the interview stage of this Assessment, in December 2006, the regulatory and inspectorate institutional structure in the energy sector was represented by the National Agency of the Kyrgyz Republic on Antimonopoly Policy and Promotion of Competition (“AMC”) and the State Inspectorate for Electricity and Gas (“Inspectorate”), respectively. A new Constitution had just been adopted in November 2006, which was then overridden by a newer one passed by Parliament at year end, and signed by the President in early 2007. The Government resigned last December and a new structure of the government was adopted in early February 2007.

At the finalization of this Assessment in mid-February (the Assessment, while completed in January has been updated to reflect the recent changes to the government that affect the energy sector) the full range of formative legislative documents required to effect the changes have not yet been adopted. The process of appointing the new Government is just completed, including a new Ministry in charge of energy, industry and fuel resources. Given its breadth, this Ministry will require significant resources and capacity to address the significant economic areas under its charge. The full extent of restructuring that will be required as a result of the new government structure at this point is unknown. Certainly, as discussed more fully in the body of this Assessment, flowing from the existing conflict between the February Law on the Structure of the Government and the pre-existing Energy and Electricity Laws with respect to the status and structure of the regulatory authority, it is uncertain how the institutional structure and competencies of the regulatory authority will develop over the next several months. One of the proposals under discussion, for example, envisages establishment a regulatory body in the form of the State Energy Agency under the new Ministry of Energy, Industry and Fuel Resources. It is expected that the State Energy Agency will formally established by the end of February 2007.

A unique set of circumstances are presented by the recent changes to the government structure in the Kyrgyz Republic and, in particular, their impact on the energy sector, and the rare opportunity for sector reform it creates. Given this, we recommend that the legal and regulatory development component of REMAP with respect to the Kyrgyz Republic focus not on commenting on individual secondary legislation nor technical rules for cross-border trade or export, but rather on fundamental changes to primary legislation that would not only update the laws but introduce clarity and certainty through institution building and governance.

To this end, we recommend the establishment of a High Level Working Group with a mandate to reform the Energy and Electricity Laws, including a determination of the appropriate policy and regulatory institutional roles.

The success of such group depends on buy-in at the most senior level, with leadership of the Ministry of Energy, Industry and Fuel Resources, its key representatives, pursuant to support from the President and Prime Minister's Offices. Also important is the active participation of the State Energy Agency and the inclusion of senior representatives in the Parliament, as well from the President and Prime Minister's Office (ideally from existing or newly formed energy working groups within those institutions) and other stakeholder organizations, including but not limited to representatives from the six publicly owned energy enterprises (the generation, transmission and four distribution companies), and, as deemed appropriate in light of the new government structure, experts from the organizations that regulated and inspected the energy sector in 2006: the AMC and the Inspectorate.

Given the importance of the decisions to be made, we recommend that the Ministry of Energy, Industry and Fuel Resources, under the support of the President and Prime Minister's Offices, lead the establishment of such group, the articulation of its mandate, and the identification of its members. Targeted sub-groups could identify specific issues at hand, such as new capacity licensing requirements, affordability issues, regional trade, preferential treatment for renewables, investment incentives, and the like.

REMAP could support such group, but should not direct it. Rather, to ensure sustainable reform of the sector with buy-in from stakeholders, the process should be led by the Kyrgyz Government. Any steps by REMAP in this regard should be coordinated with any other sector reform efforts to ensure that regulatory institution building fits within an overall reform strategy. Participants in reform efforts should present a united position as to the need for institutional reconfiguration of the regulatory authority and establishment of a sound policy role exercised by the Ministry of Energy, Industry and Fuel Resources.

We note at the outset that the existing primary legislation in the energy sector and applicable secondary legislation, including the Charters of the regulatory body and the inspectorate body, offer sound bases on which to proceed. This Assessment does not recommend a complete rewriting of the energy sector legislation. Rather it recommends a process by which such legislation may be updated and amended to, *inter alia*, open the sector to greater competition, further regional trade, protect consumers and address renewable and efficiency mandates, consistent with the development of a clear, modernized energy strategy; and the institutional framework refined to include the internationally accepted attributes of a

regulatory authority: *clarity, transparency, predictability, autonomy and competency*. The recommendation of a High Level Working Group to fill this task is intended to streamline. Concentrated, directed resources with participation at the senior levels are needed; large human and financial resources are not.

III. BACKGROUND

This Assessment was conducted in light of the generally accepted attributes of a sound energy sector legal and regulatory framework; REMAP's overall goals; identified areas for reform in CAR; desired results; the general factual predicate presented by the energy sector in the Kyrgyz Republic; and regional issues. Each of these elements are explained below.

A. REMAP

1. Overall Goals

REMAP's overall goal is to assist the development of a CAR electricity market, taking into consideration the following overall objectives:

- Establish a market that is transparent and competitive
- Increase electricity trade in Central Asia
- Introduce market-based solutions for current and future regional disputes related to hydroelectricity facilities and reservoirs
- Build the capacity of CAR regulators to develop the electricity industry in the region, while protecting the interests of consumers

This Assessment, therefore, examines the current legal and regulatory framework in the Kyrgyz Republic and makes recommendations in light of these objectives and overall goals. Because the ultimate objective is a viable regional market and increased cross-border trade, this means that the legal and regulatory framework for the Kyrgyz Republic should, among other things, harmonize with those of its trading neighbors, particularly Kazakhstan and Tajikistan; and that each market participant should present a transparent and predictable regulatory environment to facilitate that trade.

2. Components

REMAP has three key components:

1. Regional Electricity Market Development
2. Market Development Policy Work with Selected Regional Energy Associations
3. Support for Electricity Sector Reforms in Kyrgyz Republic and Tajikistan

This Assessment relates to the third component. It focuses on those aspects of the current legal and regulatory framework in the Kyrgyz electricity sector that need reform in order to further the overall goal and objectives noted above.

Aside from the changes needed to conform the existing legal and regulatory framework in the Kyrgyz Republic to the model generally accepted as needed to facilitate market development (*see infra* Section III.B), USAID has identified the following as substantive areas needing reform:

- Distribution services
- Social safety net programs
- Market-based pricing and cost recovery

The Assessment's findings and recommendations take into account these focus areas for reform.

3. Desired Results

The key results identified for REMAP's first phase (the first two years) for the third component are:

- Establishment of a tariff methodology for the Kyrgyz Republic
- Input from the authorized Kyrgyz entities to regional market design
- Establishment of transparency and audit requirements for electricity exports from the Kyrgyz Republic
- Draft of a new electricity law for the Kyrgyz Republic by Kyrgyz authorities with support of REMAP consultants
- Completion of a proposal for privatization of electricity distribution in the Kyrgyz Republic

These desired results, consistent with REMAP's goals and objectives, reflect a need for the Kyrgyz legal and regulatory framework to:

- Adopt, as a foundation a new electricity law that facilitates domestic investment and regional trade
- Establish the body to serve as the energy regulatory authority as a primary regulatory body overseeing the electricity sector

- Establish a clear regulatory path for the acquisition, publication and auditing of data relating to electricity sales and monitoring of electricity transactions, particularly exports
- Create the regulatory environment that encourages strategic investment in distribution

4. Areas of Assessment

The proposed REMAP workplan identifies among its deliverables a baseline assessment of current and proposed legal and regulatory framework for the Kyrgyz Republic. The workplan provides that the assessment should characterize the Kyrgyz legal and regulatory framework to determine its capacity to support private investment and increased electricity trade by examining its treatment of:

- National Energy Security
- Private Investment
- Openness and Transparency in Regulation
- Regional Electricity Trade
- Energy Efficiency
- Environmental Protection
- Protection of Vulnerable Populations

The workplan envisions that REMAP will identify the areas in which the Kyrgyz Republic's national energy policy, laws and regulations are inconsistent or deficient with respect to the aforementioned criteria, and areas in which the Kyrgyz Republic's laws and regulations regarding cross border trade must be harmonized with those in Kazakhstan and Tajikistan.

Given the existing upheaval in the basic legal and institutional structures in the Kyrgyz Republic, the authors note that the Assessment component must by definition have multiple stages. This document provides an initial evaluation of how to move forward and improve the legal and regulatory framework in a manner consistent with the development of a sound sector and the enabling of regional trade. The first step is to identify the existing difficulties in the framework and propose the process by which reform efforts should proceed; the second step is to work with local stakeholders at the highest possible level to institute the changes necessary for revision of the laws, regulation and supporting regulatory and institutional framework.

Moreover, it will be important for sector development overall that the important work of regulating the sector go forward. Government changes and upheavals will always occur; the integrity of the sector depends on its ability to continue transparent activities irrespective of such

changes. A High Level Working Group can facilitate such continuity even as it weighs different options for changing the way the energy sector is regulated.

5. Summary

This Assessment reviews the existing Kyrgyz legal and regulatory framework in light of REMAP's goal – to facilitate the development of a regional electricity market – and the component objectives identified as a necessary part of achieving this overall goal, including improvement in distribution services, protection of vulnerable populations and rational, market-based pricing.

New primary legislation, with a coherent role for the energy regulatory authority, and a regulatory process that provides transparency with respect to export data are identified as needed areas of reform. To facilitate the needed reform, this Report recommends the establishment of a High Level Working Group. Such Group would profit most from:

- *Leadership of the Ministry of Energy, Industry and Fuel Resources, its key representatives, and active participation of the State Energy Agency, pursuant to the support of the President and Prime Minister's Office.*
- *Inclusion of senior representatives from the President and Parliament's Office (ideally from energy working groups within those institutions) and other stakeholder organizations, including but not limited to representatives from the six publicly owned energy enterprises (the generation, transmission and four distribution companies), and, as appropriate in light of the new structure of the Government, representatives from the bodies that regulated and inspected the energy sector in 2006, namely, the AMC and the Inspectorate.*
- *Support from REMAP experts in the form of technical expertise, pursuant to approval from USAID; ideally, REMAP experts would have a consulting role with respect to the High Level Working Group's efforts to draft and amend legislation, and REMAP experts would comment and offer guidance as to best international practices, in support of efforts by Kyrgyz stakeholders.*

B. Generally Accepted Attributes of a Sound Legal and Regulatory Regime in the Energy Sector

The goal of a well-functioning regional electricity market, with concomitant domestic sector reform, including the establishment of a competent regulatory authority, is a common one throughout the world. Over time, specific attributes have become accepted as necessary to create this environment. These attributes will not be repeated in depth here. Instead, included in Appendix 1 hereto are recitations of such attributes as identified by recognized authorities, *i.e.*,

- The World Bank, Handbook for Evaluating Infrastructure Regulatory Systems, 2006, Appendix A
- The Energy Regional Regulatory Association (“ERRA”) Regulatory Benchmarking Report for the CIS, 2005, drafted by Pierce Atwood and supported by USAID
- CEER Regulatory Benchmark Report for South East Europe 2005, drafted by Pierce Atwood and supported by USAID (standards and best practices set forth in the Appendices)

As these various authorities note, generally speaking and with the specifics adjusted to meet the relevant particulars of the country and region, the legal and regulatory framework in a country’s energy sector should include the following characteristics:

- **Clarity.** *Whatever the ultimate structure of the institutions in the Kyrgyz energy sector, the substance of the laws, and the design of the regional market, the rules that underpin framework should be clear, as should the chain of command, i.e. the role of each sector participant.*
- **Predictability.** *Again, whatever the model, that model should be predictable. Existing and potential sector participants should know what is expected of them and the ordinary results of their conduct.*
- **Transparency.** *Not only should laws and regulations be clear, in that everyone can understand them, but the processes used should be transparent, e.g., the methods for making decisions should be public.*
- **Autonomy.** *The body entrusted with regulatory oversight should have a core independence, which is measured by various standards, such as an independent budget, protection from at-will discharges, and ability to enforce decisions.*
- **Competency.** *The regulatory body should be well trained, consist of knowledgeable regulators and staff members, and have the resources, financial and otherwise, to carry out its duties.*

C. Investigation

The process through which the information was collected and this Assessment was prepared is as follows:

- The authors reviewed background materials listed in Appendix 3 prior to travel to the Kyrgyz Republic. These materials are a combination of those provided by USEA and researched independently by the authors.
- In addition, the authors worked with Kyrgyz representatives to gather applicable legislation, based on a list prepared by the authors.
- Ms. Bjork traveled to the Kyrgyz Republic for one week and met with stakeholders (see Appendix 4), including representatives from the Prime Minister's Office, the AMC, the State Inspectorate on Electricity and Gas, the Electric Stations Company and the National Electric Grid Company.
- Following this travel, during which additional materials were gathered and sent to translation, the authors reviewed supplemental legislative documents, and applied international best practice standards in developing this Assessment.

D. Sector Overview

1. The Kyrgyz Electricity Sector

Briefly, the aspects of the Kyrgyz electricity sector most relevant to this Assessment are as follows.

- The Kyrgyz Republic has a population of 5.12 million, 35% of whom are urban dwellers. Kazakhstan is to north, Tajikistan to south, Uzbekistan to the west, and the Xinjian region of the People's Republic of China to the east.
- The Kyrgyz Republic was the first former Soviet republic to join the World Trade Organization, is a signatory to the Energy Charter Treaty, and a participant in recent discussions (November 2006) with the European Community to define a common energy strategy with the EU.
- The major source of power in the Kyrgyz Republic is hydropower, which accounts for over 80% of the total energy production in the country. A very large hydroelectric potential (up to 164 TWh annually) exists. Current estimates are that less than 10% of this amount is currently exploited.
- Because generation is dominated by large cascades of hydroelectric generators, most of which have limited storage capacity, establishing a robust national electricity market would be difficult, while regional wholesale market development appears more promising. Hydropower reliance also means that there is a surplus of electricity in the summer, but the country may face a power deficit in the winter.
- Currently, pursuant to regional agreements, every year Kyrgyzstan, Tajikistan, Kazakhstan and Uzbekistan engage in an electricity-water trade deal to cover their water and energy needs for different times of the year.
- Partially complete hydropower stations, Kambarata No. 1 (1900 MW) and Kambarata No. 2 (360MW), are the next candidates for generation development. If they are completed, electricity available for export will increase significantly. Unified Energy Systems of Russia is the major investor in these new plants.
- The power sector is unbundled into separate joint stock companies (one for generation, one for transmission and transmission operation and four distribution companies), with the majority (93.5%) of shares publicly owned by the State Property Committee and the Social Fund.
- The unbundled generation company was founded in 2001. JSC Electric Power Stations is in charge of all major electricity production, most of which is generated from the cascade of Naryn River (which flows into the Syr Darya and through Uzbekistan, resulting in many of the water-energy nexus concerns). Three thermal power stations of relatively notable size for the sector, including the largest, in Bishkek, are multi-fuel, running largely on coal from Kazakhstan and on gas from Uzbekistan and are producing below designed levels due to the poor physical conditions and the cost of fuel imports.
- The National Grid, or JSCNG, controls the transmission grid, which is in need of upgrading, and acts as the national system operator. The northern grid is connected to

the southern grid by a 500kv line (Toktogul-Frunzenskaya line), and to the grid in southern Kazakhstan via two 500kv and four 220 kv lines. The southern grid is connected by seven 220kv lines to the Uzbek grid and a new line directly connecting Kyrgyzstan grid to Tajikistan is under feasibility study.

- Four distribution companies provide retail supply and distribution services. Service reliability is poor, commercial and technical losses high, meters are old, and outages frequent. One distribution company (SeverElectro) was targeted for a pilot concession project, but the project has been stalled by opposition to privatization. A bank specially assigned by the Kyrgyz Government (on May 25, 2002 by Resolution #335) receives payments collected by distribution companies and redistributes these revenues in accordance with the regulations of the regulatory body.
- Currently, a Kyrgyz law effectively restricts the existing generating company, JSC Electric Stations, from eliminating or selling assets, which poses problems for management in commercializing its operations, and plans for any concession, privatization or turnaround management of the distribution companies have stalled because the last stages of a government-led privatization plan have not been implemented due to political resistance.

2. The Historical and Existing Legal and Regulatory Framework

As with many countries in transition, the recent history of legal and regulatory framework in the electricity sector is characterized by initial establishment of a legal and regulatory scheme, followed by a series of changes thereto. The current status of this framework in the Kyrgyz Republic is in particular flux given the adoption of a new Constitution in November 2006, and a newer one at the end of December 2006 (and put into force in early 2007), the dissolution of the Government in December, the appointment of a new Prime Minister in January 2007 and the appointment, for the first time since 1993, of a Ministry in charge of energy issues (the Ministry of Energy, Industry and Fuel Resources) in February 2007.

Generally speaking, the legal and regulatory history of the Kyrgyz energy sector can be divided into three periods:

- *initial establishment of a regulatory regime [1996-97]*
- *attempted superseding of that existing regime through Presidential Decrees [2005-06]*
- *the current situation, in which a change back from the Presidential Decrees and possible reconfiguration of the regulatory structure is being pursued*

These changes have disrupted the development of a predictable, transparent framework.

The first modern regulatory body in the energy sector in the Kyrgyz Republic was the State Energy Agency (“SEA”), established in 1996. The SEA was mentioned for the first time in

a March 1996 Presidential Decree, On Structure and Composition of the Government of the Kyrgyz Republic, which included the SEA as one of a number of administrative agencies that would function under the Government. An April 30, 1996 Governmental Resolution implementing a Presidential Decree approved SEA's first Charter. The October 30, 1996 Law on Energy and the January 27, 1997 Law on Electricity elaborated SEA's role in the electricity sector. The SEA Charter was amended by resolutions of the Kyrgyz Government in March 1997, July 1998, April 2001, and finally in 2006 as discussed below.

In 2001, the Government approved a National Energy Strategy. A new one has been prepared, but not yet approved.

Starting in 2005, a series of actions restructured the sector, leaving it in some disarray, which has been compounded by subsequent decrees and resolutions, as well as the recent Constitutional change and resignation of the Government.

In 2005, the SEA was dissolved. More specifically, Parliament enacted the September 27, 2005 Law on Structure of Government of the Kyrgyz Republic, and the President of the Kyrgyz Republic created a working group to restructure the government. As a result of that exercise, no Ministry or other agency emerged in charge of energy. In October 2005, by Presidential Decree, most regulatory authority over the sector was given to the National Agency of the Kyrgyz Republic on Antimonopoly Policy and Promotion of Competition ("AMC"). This Decree essentially brought the SEA under the AMC. The Decree was brief and directed the Government to further develop the AMC's structure. The Decree did provide that the AMC submits an annual report to the Government, but the AMC is not within the structure of the Government and so has no direct reporting requirement to the Prime Minister. The recently adopted (February) Law on the Structure of the Government put the AMC under the direct supervision of the Prime Minister and established a new entity (that replaces the AMC) called the State Agency of the Kyrgyz Republic on Antimonopoly Policy and Promotion of Competition ("State Agency"). Though the new separation of the AMC and the SEA into autonomous institutions should provide for reallocation of energy sector regulatory functions, at present it is not yet clear if any coordination of some energy sector regulatory functions and tariff-setting in particular will be retained by the State Agency as the legal successor to the AMC.

On December 30, 2005, through a Resolution of the Kyrgyz Government, a Charter of the State Inspectorate on Energy and Gas ("Inspectorate") was approved, providing for the structure, personnel, location of offices and other details for that body. Going back a decade, the Inspectorate used to be a part of the vertically integrated monopoly called Kyrgyzenergo. In 1998, it was spun off and by a July 6, 1998 Resolution was made a part of the SEA. The October 10, 2005 Presidential Decree on Establishment of the Antimonopoly Agency placed the Inspectorate under the AMC, though five days later the Inspectorate was moved. An October 15, 2005 Presidential Decree put the Inspectorate under the Government as part of a larger governmental restructuring per a Decree on Improvement of the Structure of the State Governance Bodies of the Kyrgyz Republic. Two additional resolutions regarding its operations were issued by the Government and AMC, respectively, in July, 2005. While the Inspectorate was given the authority to issue licenses, in practice, it carried out a preliminary check of the

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license holder, then advises the AMC whether the applicant had the capability to ensure technical operation.

Another Presidential Decree, issued on February 13, 2006, approved the AMC's Charter (de facto voiding that of the SEA, followed by a formal voiding via a July 4, 2006 Government Resolution). It is important to remember here that, given recent changes, such Charter, like the decrees that predate the new government structure and that address the functions of the AMC and the Inspectorate, no longer apply. The history, however, is important to demonstrate the institutional flux of the energy sector and emphasize the need for predictability and clarity of roles going forward.

The AMC Charter specified that the AMC shall be the legal successor to the state department on antimonopoly and to the SEA. A three-month time frame was provided to develop proposals on amendments to legislation needed to implement the February 13 Decree. One notable change was that, unlike the SEA Charter, the AMC Charter provided for other sources of funding in addition to the state budget. It allowed for funds obtained through these additional sources to be set aside in a special fund account and be transferred to the AMC in full. By contrast, the SEA was funded only through the state budget. These additional monies, however, were insufficient to support the AMC and offered only funding supplemental to that AMC received from the State budget.

On October 15, 2005, another Presidential Decree was issued, listing all Ministries, State Committees, State Agencies and all other forms of executive authorities as under the Government. The October 15 Decree specifically provides that the State Inspectorate on Energy and Gas shall be formed on the basis of the State Inspectorate on Energy and Gas that had been part of the SEA. The Inspectorate, pursuant to this Decree, reported to the Prime Minister. The Decree does not, however, make reference to the SEA in any other context and makes no reference to the AMC. On September 21, 2006, Parliament issued a Resolution that essentially pushed back on the existing situation developed through Presidential Decrees.

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Notably, flowing from these changes, the Inspectorate until recently had the right to represent the country in many important regional fora, while the AMC carried out some monitoring on a regional front, with limited representational authority at the regional level. The AMC Charter allowed the AMC to be involved in the implementation of international cooperation in issues relating to the fuel and energy complex, and the AMC participated in cooperative activities with regulators on an international and regional front in Energy Regulators Regional Association and the Central Asian Regional Economic Cooperation (CAREC) program, respectively. The AMC Charter did not, however, give the AMC the right to represent the Government of the Kyrgyz Republic, which authority had instead been devolved to the Inspectorate. Given that the Inspectorate is an entity designed to handle only technical energy issues, the international role was unusual. Such international representation is, in most countries, handled by a Ministry in charge of energy. As no such Ministry previously existed in the Kyrgyz Republic (and indeed there has been no Ministry in charge of energy since 1993, excepting of course the recent establishment of one), the Inspectorate assumed this task. With establishment of the Ministry of Energy, Industry and Fuel Resources, the Inspectorate is likely to become part of the new Ministry, though no formal assignment has been made at the issuance of this

Assessment. Current institutional initiatives are many. With respect to the issues of concern to REMAP in particular, i.e., the development of regional electricity trade in the CAR, of particular relevance are the regional energy initiatives by the Commonwealth of Independent States Energy Council, the Eurasia Economic Community Energy Policy Committee and the Central Asia Coordinating Energy Council.

In November 2006, a new Constitution was passed by Parliament and signed as required for going into effect. While the old Constitution explicitly permitted the President to issue decrees to establish agencies separate from the Government, *e.g.* like the AMC, the new Constitution deleted this authority. With respect to the November Constitution, executive authorities can be established only by the Government, and thus cannot be fully independent of that Government. They can be established either in the form of a ministry or an agency, committee, or inspectorate under the Government. Both Constitutions are clear that law prevails over secondary legislation, including Presidential decrees and Government resolutions. Furthermore, the Law on Legal and Statutory Acts states that in the event of a contradiction or discrepancy between a decree of the President and a law, the law shall prevail. Another Constitution, the fourth one since the country's independence, was passed by Parliament at the end of 2006 and was adopted in early 2007. **The December Constitution did not revive an authority of the President to establish executive authorities separate from the Government, and any executive agency formed in Kyrgyzstan, including a regulatory authority, can not be fully independent of the Government.** [Olga, I think we really do need to figure out if the new Constitution allows the formation of independent bodies; if it does not, we need to say that, if it does, we need to note the possibility and its improvement over the restriction of such possibility in the November Constitution].

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¶ The newly adopted Constitution requires a revision in the Law on Structure of the Government. Such a law is anticipated to reconfigure the Ministries. The decision to create a Ministry of Energy, Industry and Fuel Resources is one change that will be reflected in the Law on Structure of the Government.

To summarize, the current legal and regulatory framework is confused and the result is a set of institutional structures where responsibilities and obligations are opaque rather than transparent, and ephemeral rather than predictable. Presidential Decrees attempted to supersede the laws enacted in 1996 and 1997 and as a matter of practicality did eliminate the SEA, which was subsumed into the newly established AMC, and removed the Inspectorate from the SEA framework, transferring it under Government authority. Most recently, the Government itself was dissolved, a new Prime Minister is in place, a Ministry of Energy, Industry and Fuel Resources has just been established and other government structures are in development.

IV. PRINCIPAL FINDINGS

A. The Need for Clarity and Development of a New Legal and Regulatory Framework

In a typical case, existing laws and regulations would be reviewed in accordance with the general standards outlined in Section III.B., above. For example, the framework would be checked to ensure that the regulatory body had authority to issue licenses, set tariffs and monitor the market; had sufficient indicia of authority, resources, and an ethical code; and carried out its responsibilities through transparent processes. Accounting practices would be checked to ensure an efficient flow of information allowing the regulatory body to identify whether cross-subsidization was occurring, and to otherwise perform its tasks.

Similarly, the existing laws and regulations would be examined to review provisions relating to national energy security; private investment, openness and transparency in regulation, regional electricity trade, energy efficiency, environmental protection and protection of vulnerable populations and to evaluate their sufficiency of those provisions.

The legal structure would be analyzed to determine whether, as a practical matter, administrative, structural or other barriers affected implementation of the legal framework. Questions would be directed to stakeholders to assess the gaps, if any, between the existing legal and regulatory regime in terms of the legislation on paper and the practical implementation of such laws (including all Government resolutions, Presidential decrees, charters and the like).

The current framework is confused, and a moving target. The first principle of any legal and regulatory framework, clarity, is not being met. Most importantly, we understand that the regulatory framework is expected to be reconfigured, and, moreover, that the decision as to the ultimate governance of the regulatory institution is under review. In this situation, it would be inefficient to try to discern what the existing situation may or may not be, instead of concentrating on how best to maximize the opportunity presented to develop an institutional structure with a coherent and understandable framework to promote power sector development.

B. The Role of the Regulator(s)

A core part of bringing coherency to the sector should be clearly identifying the powers of the relevant regulatory bodies. Currently the revived State Energy Agency is being proposed for regulation of the energy sector and its structural relationship with the Ministry of Energy, Industry and Fuel Resources is being defined.

The key is that regulatory competencies are clearly identified in law, and procedures are developed to protect the ability of the regulatory authority to carry out those competencies in a public and transparent manner.

We note that any more in depth work on developing the institutional structure of the regulatory authority may consider work already underway in developing a regulatory framework in the Kyrgyz telecommunications sector.

C. Tariff Reform

As a part of this exercise in developing a coherent framework, changes should be made to rationalize pricing, and to create incentives to commercialize and otherwise improve supply, while protecting vulnerable populations. The development of cost reflective tariffs and investigation of options for affordability are addressed in a different aspect of the REMAP work, and a separate report will be issued on these subjects. Most important, however, is that the

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regulatory body is able to make tariff decisions pursuant to a process and methodology that is transparent.

Until recently the AMC was authorized to set tariffs, but there is no tariff methodology in place. The Government approved the general tariff policy developed by the AMC, and the specific tariffs themselves were set by the AMC in a form of the regulatory resolutions. Pursuant to the new law on the Structure of the Government the Ministry of Energy, Industry and Fuel Resources was formed, which is expected to have in its structure the State Energy Agency, previously incorporated with the AMC. It is anticipated that tariff setting will be administered by the SEA, however, currently it is not clear if the legal successor of the AMC will have a role in coordination of the tariff setting.

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Ideally, the regulatory authority would be able to define the tariff methodology, based on a reasoned assessment, after public consultation, of any changes necessary to pursue a more cost reflective tariff structure, while protecting consumers. It is important, moreover, that a clear structure of advice and recommendations, with each decision issued publicly, be set in place. Only in this way are utilities and consumers aware of positions put forth by the regulatory authority, and can develop confidence that the regulatory authority is considering their comments and interests.

D. Implementation of the National Energy Strategy

As a threshold issue, a draft National Strategy has been on the table for some time. It is important that any national strategy address developments in the sector and plans for cross-border activity. Development of the National Energy Strategy should occur in concert with regional market development initiatives and ideally, should act as the foundation for all institutional reforms in the sector.

As reflected above, confusion as to the proper role of various bodies extends to the international and regional arena.

A coherent framework is needed that sorts out the proper roles for each sector participant in promoting a regional energy market, carrying out cross-border transactions, and entering into legally enforceable agreements. This should be a key role of the Ministry of Energy, Industry and Fuel Resources in the first two quarters in office.

E. Investment

Given the hydro potential in the Kyrgyz Republic, not only should the legal and regulatory framework be improved to encourage strategic investors to enter the market, but coherent mechanisms should be established to make such investments transparent and to retain strong

regulatory control over the investors. This means that the National Energy Strategy and then the primary and secondary legislation must create a climate for open competition. This climate must also allow measures to be taken to protect security of supply and vulnerable (as well as remote) customers, thus requiring a careful balance that should be reflected first in national policy and then in legislation.

On April 23, 1997, the Government approved the Program for Denationalization of Kyrgyzenergo (the formally vertically integrated enterprise), which was revised one year later on June 5, 1998. Both versions of the Program set forth four stages for restructuring and privatization of the energy sector. The first three stages are complete; the fourth is stalled as a result of political resistance. The fourth stage calls for tenders for the sale of up to 70% of the shares of the distribution companies to strategic investors and the transfer of management rights for the generation companies and the transmission company (with the state retaining the controlling shares). On May 24, 2006, the Kyrgyz Government passed a Resolution officially requesting approval of the Parliament for privatization of the electricity distribution companies and heat distribution companies through concessions, management contract or sale of the state's shares in the companies. This Resolution has been approved by the applicable legislative committee and is currently pending approval of the Parliament. While this reflects real, if incomplete, progress, in the mean time, it is important to note that the Law on Special Status of the Toktogul Cascade of Hydropower Plants and the National High Voltage Transmission Grid restricts the JSC Power Plants (the large generating company) from selling, pawning, or transferring management to any party without the approval of Parliament, thus severely impeding its ability to streamline its corporate holdings or turn around management.

Certainly investors need to know that administrative and procedural requirements (such as lengthy and multi-agency licensing obligations) will not impede attempts to do business. Substantively, if competition is indeed the goal, then restrictions on privatization must be diminished in part if not in full for generation and distribution. Investment will not occur in an uncertain, unstable and unpredictable regulatory environment. Finally, investors care about the bottom line: they must know that the tariff structure will allow a reasonable return on investment. In each of these four areas, significant steps toward reform are required in the Kyrgyz Republic.

The Kyrgyz Republic scored 71st out of 157 countries on the 2006 Transparency International Index of Economic Freedom, toward the bottom of the 2nd out of 4 overall categories, with 1 being the best. It ranks far above all other CAR countries (with Kazakhstan at 113, Tajikistan at 137, Uzbekistan at 144 and Turkmenistan at 148). Thus, the overall climate for investment and competition is arguably the best in the region, and prospects for successful sector development, power export and trade exist, as long as energy sector development continues in the right direction.

V. PRINCIPAL RECOMMENDATIONS (ROADMAP)

The REMAP workplan notes that the result from this Assessment should be a Legal and Regulatory Reform Roadmap containing a detailed set of recommendations for regulatory reform

deriving from a consultative process with counterpart agencies. In this first stage Assessment, the goal is to list potential recommendations, which can then be reviewed, discussed, prioritized and fleshed out in the referenced consultative process.

Given the fundamental changes anticipated in the Kyrgyz Republic energy sector (at the ministerial and regulatory level) we recommend that steps to clarify and reform existing legislation and regulatory governance and competencies be explored in greater depth and decided via a High Level Working Group, spearheaded by the new Ministry of Energy, Industry and Fuel Resources, pursuant to support of the President and Prime Minister's Offices. We would anticipate that such Working Group would have subgroups that focus on discrete issues.

A. Primary

- *New Energy and Electricity Laws and Regulatory Body Charter and Internal Rules*

The legal and regulatory slate should be significantly revised, in that a comprehensive package of laws that replace the existing laws and regulations should be prepared and enacted that clearly spells out the role of each sector participant. The attributes of the regulatory body should be reflected in the new laws and the new charter and internal rules for the body.

Aside from comporting with the Constitution, such new laws should include, consistent with international best practices:

- *Identification of the policy leadership role of the Ministry of Energy, Industry and Fuel Resources.*
- *Provisions identifying the regulatory authority in the energy sector, setting forth its governance structure, and granting it clear power and resources to carry out primary regulatory responsibilities. The regulatory agency should be given the recognized attributes of a sound regulatory body identified in Section III.B and Appendix 1.*
- *Identification of the body or unit in charge of inspection, with its primary function to oversee technical and engineering compliance.*

In developing these laws, an effort should be made to provide continuity by utilizing the viable aspects of previous Kyrgyz legislation in this area, and to harmonize with the laws of its trading partners. As institutional roles are clarified through revised legislation, sound individual expertise in existing institutions must be maximized and utilized as part of the new institutional structure. Such individuals too will be critical to maintain the integrity of the Kyrgyz power sector during any interim period where the regulatory and legal framework is under revision.

On the regional front, the law should delineate policy issues to be determined by the Ministry of Energy, Industry and Fuel Resources, with clear identification of the regional responsibilities of other sector institutions, such as the regulatory body and the inspectorate body, consistent with the competencies performed under the laws.

We would recommend that any assistance offered to the energy sector in the Kyrgyz Republic through USAID be coordinated with any other efforts in the area of regulatory and Ministry development, to avoid inconsistency or duplication, and to develop the consensus needed to effect change.

- *Establishment of a Working Group*

To achieve these changes, a High Level Working Group, approved at the Government and Parliamentary level, should be established with a clear mandate to revise the Energy and Electricity Laws.

To ensure sustainable sector reform, the High Level Working Group should be Kyrgyz formed and led, with authorization at the highest possible level and a clear set of expectations of outcome. Consultants should have specific tasks and target areas of assistance, but not direct activities.

The Ministry of Energy, Industry and Fuel Resources is best suited to direct the activities of the group, which would include senior representatives from the President and Prime Minister's Offices, and from the energy enterprises and other stakeholders. Such group, to be successful in the short, medium and long term, must exist pursuant to authority and support granted by the President and Prime Minister's Offices. Because the issues involved go to the heart of energy sector development, on a national and regional level, the success of such Working Group depends on commitment and involvement at the highest levels of Kyrgyz Government, aided by vigorous REMAP support.

We recommend that the High Level Working Group would, among other activities:

- *Examine models of energy regulatory bodies around the world with priority for those in the region. Certainly, Kazakhstan offers a model that should be closely examined. Similarly, developments in Pakistan and in the EU should be reviewed, as the Kyrgyz Republic has recently agreed to explore a common energy strategy with the latter and is exploring the possibilities of exporting to the former. International best practice can be studied and lessons learned and their application to the Kyrgyz and CAR context considered in depth.*
- *Engage in extensive consideration of regional harmonization and specific Kyrgyz circumstances. For regional market development to thrive, laws must be reasonably harmonized while maintaining core national priorities, concerns and characteristics.*
- *Develop primary legislation (electricity and energy law at minimum, possibly also a market law). The regulatory body charter and rules should be developed simultaneously, so as to create a coherent and consistent whole.*
- *Consider competition goals, privatization objectives, and legislative barriers and the accompanying revisions that may be necessary.*

B. Secondary

- Market Law

Commentary on the draft market law and other existing draft laws could be provided, but should occur within the framework of revised primary legislation and institutional governance structures, as set forth in the list of primary objectives. Thus, one of the present frustrations is that several draft market laws are in circulation; the national energy strategy is also in draft form with multiple comments already written. It does not make sense to offer additional comment at this time, as the overall structure of the sector appears to be in transition and subject to imminent remodeling.

- Institutional Capacity Building of the Regulatory Body and the Ministry of Energy, Industry and Fuel Resources

Once agreement on the regulatory structure is reached, institutional capacity building will be essential. With respect to the Ministry of Energy, Industry and Fuel Resources, how to effectively develop policy, interaction with stakeholders and the regional role must be developed. On the regulatory level, training is needed in multiple areas, including process oriented ones (reviewing license applications, public tariff hearings, media relations) and technical ones (calculation of different types of tariffs, developing regulatory uniform systems of accounts, mechanisms for monitoring regulated industries).

- Renewable Energy and Energy Efficiency

Renewable energy is an increasing concern internationally. Any National Energy Strategy should identify national interests and goals with respect to renewable energy development, and should address the issue whether to assign preferential pricing and treatment to renewable energy ventures. Following National Energy Strategy directives, it may be worth considering a separate law on renewables; a reasonable alternative is the inclusion of issues of renewables in the Laws on Energy and Electricity. Thus, whether attention to renewable energy is a primary or secondary goal depends on Government priorities in the immediate term, though certainly in the long term, attention to renewables is essential.

Revision of the 1998 Law on Energy Savings to incorporate advances in energy efficiency measures is also a vital component of energy security and affordability priorities.

VI. CONCLUSION

The situation in the Kyrgyz Republic presents a unique opportunity to bring coherence to its legal and regulatory framework. While we recommend that, from one perspective, the core legislative framework for the energy sector be rewritten, replaced by new primary legislation and ultimately the supporting bylaws and other secondary legislation, we are not advocating that the lessons from experiences since the beginning of market reform should be ignored or forgotten. To the contrary, the new laws should build upon accumulated knowledge. Much work has been done to develop the Kyrgyz power sector and indeed further regional trade initiatives. As a High Level Working Group goes forward on redevelopment of the existing legal and regulatory framework, suggestions and lessons learned are essential parts of any consideration.

Due to the gravity and uncertainty of the existing Constitutional and Government changes in the Kyrgyz Republic, the instability of the regulatory institutions and framework in the last two years in particular, and the importance and potential of the power sector in the Kyrgyz Republic (on a national and regional trade level), we recommend that action be taken quickly to establish a High Level Working Group with an explicit mandate to revise the primary energy legislation and develop the corresponding institutional framework required for an effective energy sector.

To this end, we recommend aligned positions and actions of USAID and other donors, to support and encourage High Level Working Group formation and formal authorization and direction at the Ministry of Energy, Industry and Fuel Resources level, with the support of the President and Prime Minister's Offices. REMAP is prepared and eager to assist in this effort, at the direction of USAID.